THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 360 **MAY 2003**

My main theme is to be an attempt to analyse the originating causes of the slump. For unless we understand these — unless our analysis is correct — I do not see how we can hope to find the cure… Now what was the leading characteristic of this period? Where and how were the seeds of the subsequent trouble being sown?

John Maynard Keynes, *The Originating Causes of World-Unemployment*, 1931

IMPEDING RECOVERY

While war news was stealing attention and headlines, bad and progressively worsening economic news has been proliferating around the world. There was little inclination to take notice. The conventional, comforting wisdom held that war jitters were temporarily holding back business and consumer spending. Financial uncertainties related to the U.S. war with Iraq threaten to stymie a nascent global economic recovery, declared the International Monetary Fund in a recently released report.

We keep wondering how much understanding really exists among international institutions, governments and private economists of the true, deep-rooted, structural impediments that are choking economic growth around the world, in particular in the United States. Manifestly, it was homegrown economic forces, not geopolitical risks, that triggered the 2001 U.S. and global downturn.

The major economies of the developed world appear to have contracted in the first quarter of 2003. Not only is this true of industrial activity in the United States, Europe and Japan, but also most barometers of service sector activity equally suggest growing weakness. At best, there has been overall fractional growth. What's more, the available data, going generally from bad to worse, allow no reasonable hope for meaningful improvement in the foreseeable future.

With growth prospects remaining decidedly subpar in Japan and Europe, all eyes are again directed towards the United States in great hope that its economy will quite soon take over again as the world economy's superb locomotive of growth. Effectively, it is the country where both the government and central bank have embarked on expansionary policies with an aggressiveness that has no parallel in history. Manifestly, they are determined to do better than the Fed in 1929–30 and the Bank of Japan in the early 1990s.

It is dogma in America — quoting Milton Friedman and A.J. Schwartz from their *Monetary History of the United States, 1867–1960 — "that the monetary collapse from 1929 to 1933 was not an inevitable consequence of what had gone before. It was a result of the policies followed during those years. Alternative policies that could have halted the monetary debacle were available throughout those years. Though the Reserve System proclaimed that it was following an easy-money policy, in fact it followed an exceedingly tight policy."*

If the most lavish monetary and fiscal easing in history, as presently pursued in the United States, is as almighty as many American economists seem to believe, the U.S. economy ought to be booming again soon. Money and credit keep expanding in excess of GDP growth as never before. For several years now we have witnessed in America the world's greatest money and credit deluge of all times. But there is something most amazing and meanwhile also most worrying about this deluge, and that is its extremely poor effects on the economy and in particular on the stock market.

Recently, U.S. Treasury Secretary John Snow stated: *"We are hosting the G7 ministers this time, and the meetings of the World Bank and the IMF. And I intend to introduce one broad theme to my colleagues. And that*

is the United States is not growing fast enough and neither are you, but we are growing a lot faster than you are… And can't we find an agreement on the need for the world economy to grow faster. We get complaints from our friends around the world who say, 'your current account deficit is so high.'

"And our response is: 'Yea. You know why? Because you don't buy enough from us. And because we provide the highest risk-adjusted returns on capital in the world, so your capital flows over here. So why don't you take steps to improve your domestic economy so you'll be stronger and buy more from us? And you might think as well about steps to improve return on invested capital, and then capital would flow your way as well as to the United States. ***The fact is the American economy is strong. The underpinnings are good."***

PERVASIVE OPTIMISM

How strong is the U.S. economy really? What can the rest of the world expect from it in coming years? From what we generally read and hear about it from all corners of the world, we have to conclude that Mr. Snow has a lot of company in this highly positive assessment. Whenever we speak with people about America's great economic problems that worry us, there is always the very same stereotypical response: *"But the U.S. economy is in better shape than those of Europe or Japan."*

Typical of this widespread perception was a recent remark in the London *Economist*. It said: *"America's relative strength owes a lot to flexibility of its economy and to continuing strong growth in productivity. But it also comes from fortuitously good macroeconomic policy. As the economy stumbled over the past two years, the Federal Reserve cut interest rates dramatically and quickly… If the economy falters once more, the Fed is likely to respond again. Fiscal policy, too, has given a boost, as America's budget has swung sharply into deficit…"*

America's economy, too, has faltered, but in comparison with the still-weaker economies of Europe and Japan, it appears strong. That is the prevailing perception around the world. In addition, as the London *Economist* emphasizes, it is the one country in the world where the economic weakness is being attacked with very aggressive monetary and fiscal measures. All this seems to make a compelling case for the assumption that the U.S. economy will, of course, lead the coming global recovery.

Assessing the U.S. economy's prospects, we have the impression that despite all the disappointments and the bad economic news, there remains in general a pervasive optimism. In this view, the worst is definitely over for the economy, and recovery is around the corner. The only debatable question is its strength.

Meanwhile, within just 18 months the dollar has lost almost 30% against the euro. That is quite a plunge for the world's key currency. Shorting the dollar against the euro was by far the most lucrative speculative play last year. With available leverage, it was easy to make record gains on the invested equity. What's more, with dollar interest rates below euro interest rates, dollar shorting costs almost nothing. Yet inquiring among banks, we were told that such speculation has been a rarity.

There is a widespread view that a strong economy implies a strong currency and that economic weakness leads to currency depreciation. The argument is straightforward: stronger rates of economic growth translate into higher corporate profitability, making foreign direct investment and stock purchases more appealing. This leads to higher capital inflows into the stronger-growth country, boosting the value of its assets, including shares, property and its currency.

Given this widely held view about the relationship between economic growth and currency strength and a general assumption that the U.S. economy will rebound earlier and much faster than the euro zone economy, bullishness about the euro is very tentative. We are tempted to say that it is nonexistent. Its prolonged and steep surge has taken the world financial community completely by surprise.

In the same vein, this explains European firms' complaints that the euro's sharp rise is spoiling their exports to the United States. Of course, they had the possibility to lock in the dollar's former high market valuations against the euro for many years. It even would have brought them a small interest gain. But the widespread view

that the U.S. economy's better performance implies, sooner or later, a stronger dollar prevented most of them from taking such action.

The historical fact rather is that exchange rates are primarily determined by a country's current account. With all its economic weakness and even near-zero interest rates, Japan's currency has remained very strong, with the Bank of Japan holding it down with repeated interventions.

Currency strength of a deficit country depends on contingent influences on its capital account. In the 1980s, the dollar soared in the face of a soaring U.S. trade deficit because the Fed's tight monetary policy bolstered U.S. capital inflows through soaring foreign bank lending to American firms. In contrast, the dollar's big rise during the second half of the 1990s reflected capital inflows through the markets propelled by the perception that the trumpeted U.S. new paradigm economy was the most efficient in the world, generating the most attractive rates of return.

DECEPTIVE ECONOMIC STRENGTH

Inherent weakness or strength of the U.S. economy and its currency is plainly the single most important issue in this U.S.-centric world economy. It also happens to be the issue in which we have been in diametric dissent with the global consensus for many years. We never bought the new paradigm story about the U.S. economy.

It was, actually, simple macroeconomic reflections that determined our flat revulsion of America's widely hailed new equity culture right from the beginning. Ever since we started studying economics, it was a truism for us that the crucial test of economic policies and corporate strategies is whether and to what extent they contribute to building the economy's productive capital stock, enhancing in this way both long-term economic growth and international competitiveness.

Judging an economy's performance from a long-term perspective, we therefore strictly focus on three economic features: *first*, investment resources (available savings); *second*, investment incentives (profit prospects); and *third*, actual capital formation.

From this perspective of resource allocation between consumption and investment, the U.S. economy's development in the late 1990s has been manifestly outright destructive. True, the GDP aggregate showed stellar economic growth rates for years, while Europe and Japan muddled and stumbled along. But in reality this strength in the aggregate disguised a very ill-structured growth pattern.

The obvious prime driver of the U.S. economy's stellar growth during the past several years was the false new paradigm euphoria. But instead of unleashing an investment boom, the consumer went on a consumption binge, saving less and less and piling up debts — the equivalent of heavy dissaving.

Enjoying the steep rise in stock prices, policymakers, economists and investors were totally blind to its intrinsic, malign counterparts in the economy: shrinking capital investment, a surging trade deficit and sliding corporate profits. Increasing demand for consumer goods essentially decreases the resources that are available for capital investment. The old economists used to call this capital consumption.

But how has this massive shift in the use of resources in the U.S. economy in favor of consumption actually come about? Who or what was responsible? To us, the answer has been patently clear for years. It had and has two main causes.

The primary cause was plainly the money and credit deluge with which Fed Chairman Alan Greenspan has been flooding the economy and its financial markets for years. By providing the preposterous wealth gains of private households in the stock market, he was mainly responsible for the extraordinary consumer borrowing and spending binge that the phenomenal personal wealth gains inspired.

PHONY WEALTH CREATION

Yet this gross structural maladjustment in resource allocation had still another major cause that worked on the corporate level, and most ironically, it has to do with America's new equity culture. Faced with the new

obligation to pursue first and foremost the maximization of shareholder value, an obsession developed on the part of corporate managers to oblige under all circumstances with faster and fatter profit creation than in the past.

One outcome was a drastic shift in corporate strategies for profit creation away from inherently slow organic growth through new investment and towards all kinds of financial engineering that seemed to promise both faster and bigger profits. In consequence, this new corporate culture came to promote mergers and acquisitions and many sorts of cost-cutting as the presumably safest ways to boost profits and shareholder value in the short run.

As stock prices, indeed, skyrocketed as never before, it was hailed as a new, more efficient capitalism. For us, all this was sheer economic folly and perversity that could only lead to national impoverishment. It reflected a thinking that no longer distinguished between financial manipulation and economic reality. It is a thinking that fails to see the diametric difference in economic effects between building factories and raising their market valuation.

For generations it has been an economic truism and a matter of simple common sense that in essence a person or a nation can only become richer if it consumes less than it produces. It has been left to the present generation of American economists to postulate that rising market values of assets represent an equivalent wealth creation that allows people or a nation to consume in excess of current production.

A measure of the spending excess is America's current-account deficit, now running at an annual rate of more than 5% of GDP. Since 1997 this deficit has accumulated to more than $1.4 trillion. This compares with overall national income growth of $1.23 trillion and overall debt growth of the private nonfinancial sector of $5.5 trillion during this period.

The key question about debt growth is always its use. Was it for productive or for unproductive purposes? It is obvious and undisputed that America's debt explosion has overwhelmingly been used for unproductive purposes. Private households borrowed mainly to spend for higher consumption, and corporate borrowing went mainly into gross overpayments for mergers and acquisitions, capitalized as goodwill, and stock repurchases.

Ultimately, all questions about a rise in stock and house prices boil down to the one key question of whether or not this represents true wealth creation. After careful consideration of all correlated effects, our answer is a categorical no. It is pseudo or paper wealth that enriches nobody.

A general rise in asset prices essentially means that they become more expensive for new buyers. Except for their owners, this inherently impoverishes the community as a whole since all future buyers have to pay the higher prices. But even for the asset owners, it is only a one-off pseudo gain because for them, too, it means correspondingly higher prices for any future purchases. For good reasons, the old economists flatly discarded the idea of wealth creation through rising asset prices as an illusion.

Another crucial negative point concerning this apparent wealth creation through higher market valuations, in contrast to wealth creation through new investment, is the complete absence of any income generation. In order to use their wealth for the purchase of goods and services, the owners either have to sell a part of their assets or use them as collateral for borrowing, both implying impoverishment.

CORPORATE SELF-MUTILATION

To create wealth through rising asset prices is the one great fallacy and folly in America's shareholder value model. To create business profits through mergers and acquisitions and cost-cutting is the other big fallacy and folly that has done great and lasting damage to the economy. The reality is that Corporate America's profit performance has persistently gone from bad to worse since the early 1980s.

The thing to see is that this has happened not despite these new strategies, but because of them. Narrow-minded microeconomics, focusing exclusively on shareholder value, clashed with the compelling, opposite laws of macroeconomics. What looked like new, highly sophisticated microeconomics was from the macro perspective utter economic nonsense.

By manipulating share prices upward through grossly overpaid mergers and acquisitions, managers satisfied their shareholders and themselves. That is, of course, the aspired, supreme goal of America's new equity culture.

But unfortunately, this spectacular and highly desired effect on market valuations involves a whole variety of macroeconomic effects — on profits, business fixed investment, debt levels, balance sheets, interest expenses, corporate net worth, the current-account deficit — that, on balance, overwhelmingly harm the economy. It is virtual, corporate self-mutilation.

IT STARTED IN THE 1980s

Trying to assess the past, present and future, we have traced and explored the development of these harmful effects in detail back to the 1980s. As to the most recent development, we have to say that across the board these features and signs lack any meaningful improvement, suggesting to us that the U.S. economy is close to a relapse into recession.

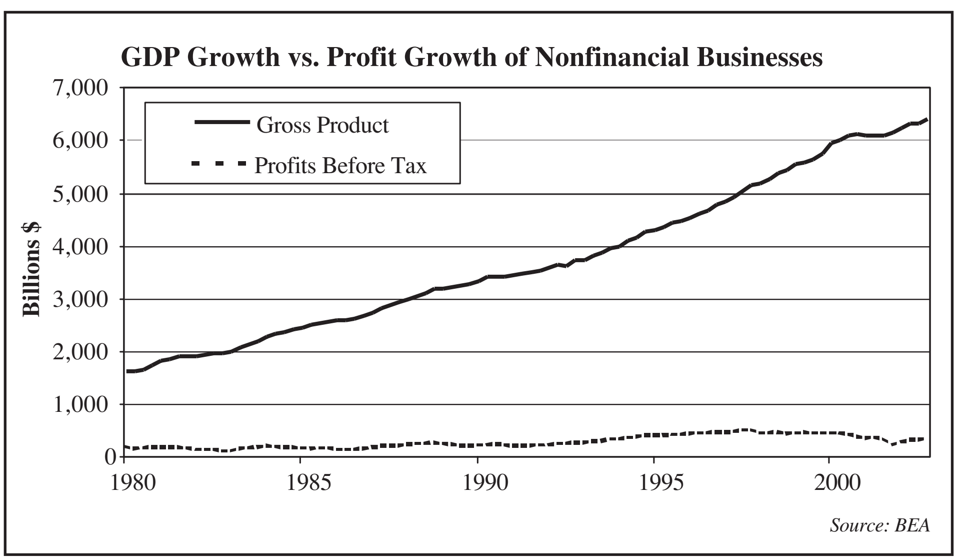
America's economy is by long tradition a high-consumption economy with low rates of saving and investment. Remedying this structural deficiency was the declared primary aim of the much-heralded supply-side Reaganomics. In hindsight, it is plainly evident that this experiment grossly failed on all accounts. Rather, national savings and net capital investment plunged to unprecedented new lows. Profits and net investment, two other key measurements, were virtually flat over the whole period, implying for both a steep fall as a share of GDP.

As promised, the economy was effectively restructured, but exactly opposite to the declared intention. In 1989, personal consumption accounted for 65.5% of GDP, as against 62% in 1979. At the same time, the share of gross fixed investment in the nonfinancial sector shrank from 12.9% to 11.1% of GDP. National saving temporarily fell to 2% of GDP, compared with an average of almost 8% in the 1970s. The current account of the balance of payments exploded between 1981–87 from a small surplus into a deficit equal to 3.5% of GDP.

What propelled the economy's growth during these years was definitely not booming corporate investment on the economy's supply side, but soaring credit and debt growth on the part of consumers and the federal government, driving the economy's recovery from the demand side.

Corporations, too, stepped up their new borrowing. For the first time, though, it was not for new investment, but mostly for mergers, acquisitions, stock repurchases and leveraged buyouts. As corporate debt soared while new investment lingered, the corporate sector's net worth suffered a steep decline. It was the obvious beginning of America's casino capitalism, in which corporations are supposed to make money without any regard to the real economy.

Measured by the GDP aggregate, economic growth appeared quite stellar, yet its pattern and structure was grossly imbalanced. After a brief, sharp spurt, business fixed investment faltered again. Business profits went nowhere, while the economy's current account skyrocketed temporarily into a huge deficit.



Assessing an economy's development, we focus, first of all, on two aggregates: trends in net investment and profits of the nonfinancial sector. During

the 1980s both went nowhere in the United States. Measured as a percentage of GDP, they ended the decade at record lows. Far from improving the economy's supply side, Reaganomics had drastically ravaged it.

WHAT IS DIFFERENT THIS TIME?

We come to the 1990s. Actually, they divide into two strikingly different parts. For the consensus, the years until 1996 are the bad part with subpar economic growth, while the following years became the great, new paradigm years.

Healthy economic growth, as we have stressed many times, shows primarily in high rates of capital formation and profit growth. Both always go together. By these two measures, the U.S. economy performed best in the first half of the 1990s and miserably in the 1980s and the late 1990s.

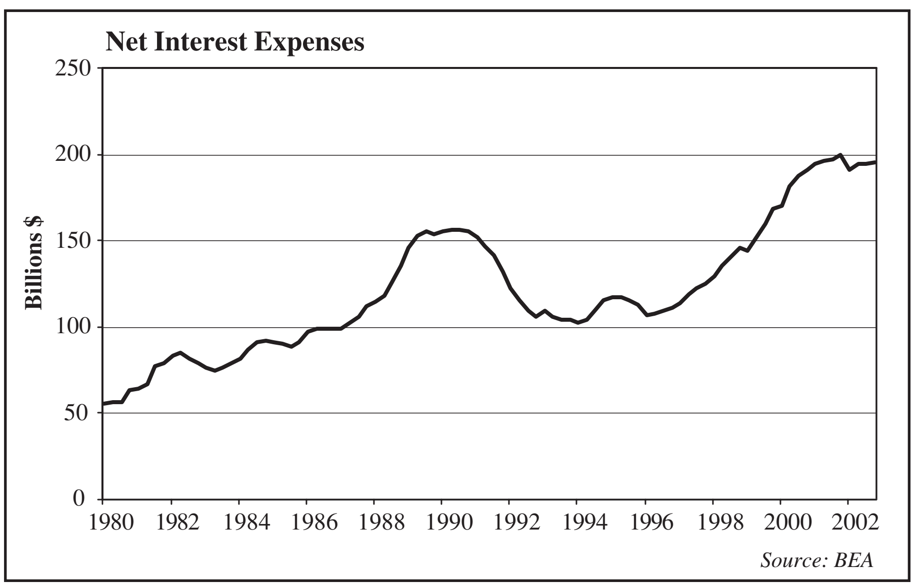
Actually, profits and net capital formation had their most excellent performance in more than two decades in the first half of the 1990s. After their protracted, poor growth in the 1980s, both suddenly took off in steep upward curves.

Before-tax profits of the nonresidential and nonfinancial sector soared from their recession-low of $226.5 billion in 1991 straight towards $504.5 billion in 1997, more than doubling within six years. Even more impressive was an unprecedented steep rise in nonresidential net investment from barely $100 billion in 1991–92 to $407.3 billion in 1997, virtually quadrupling. It was a typical investment-led cyclical recovery.

Now compare what happened to these two crucial aggregates in the following three new-paradigm boom years from 1997 to 2000. Profits abruptly slumped from $504.5 billion to $423. Nonresidential net investment continued to grow from $299.7 billion in 1997 to $407.3 billion in 2000, but it did so at a sharply slower pace than in the seven years before.

We have reviewed this recovery of the U.S. economy in the early 1990s in the hope of finding some clues for the present situation. We did, but these clues are overwhelmingly on the negative side. Considering profit prospects as the single most important condition for a sustained economic recovery, we have focused in particular at the specific causes behind the sharp profit recovery in the early 1990s and found that all of them are presently missing. What are the main differences?

(1) INTEREST CHARGES

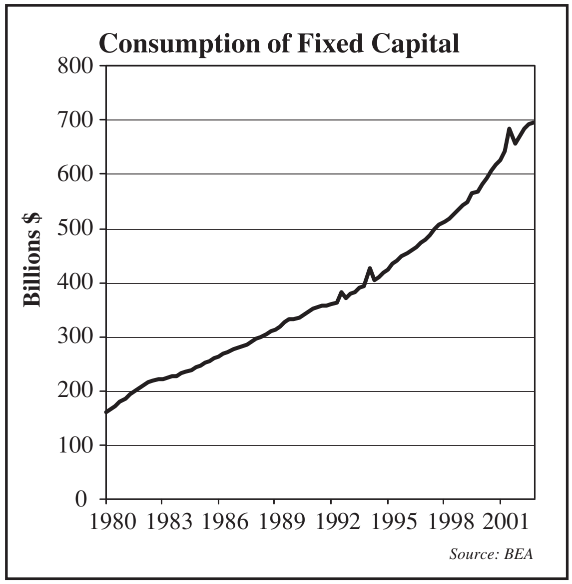


A very obvious difference exists, first of all, in the development of corporate interest expenses. In the early 1990s, corporate earnings profited heavily from a steep decline in the burden of their interest charges. In 1996, interest expenses of $108 billion compared with before-tax profits of $460 billion. That was a tremendous improvement in comparison to 1990, when interest expenses of $156 billion had compared with before-tax profits of $329 billion. But now to the horrible present: In 2002, annual interest charges of about $193 billion compared with before-tax profits of about $320 billion.

As a matter of fact, a profit-boosting sharp decline of interest charges has been typical of all cyclical recoveries. One obvious condition is falling interest rates. This time, the Fed has slashed its rate to an

unprecedented postwar low. But this time the other key condition for lowering interest expenses has remained completely missing.

This key condition is a strong and receptive stock market, allowing corporations to retire outstanding debt by issuing equity. For the first time ever in the whole postwar period, even the most aggressive monetary easing has failed to revive the stock market. Implicitly, debt levels for the corporate sector as a whole are remaining at an all-time high relative to the size of the economy, maintaining interest charges at an exorbitantly high level.



(2) DEPRECIATION CHARGES

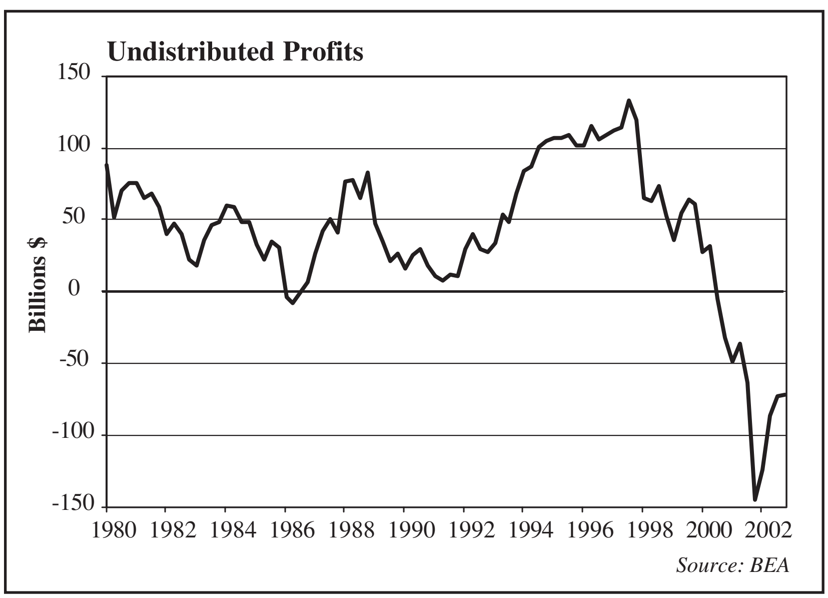
An even bigger drag on profits than interest expenses is coming from soaring depreciation charges (capital consumption). Because the composition of corporate investment in the United States has drastically shifted toward short-lived high-tech investment, such as computers, a rapidly growing proportion of gross investment represents replacement of existing capital stock, involving equally soaring depreciation charges.

The trouble is that depreciation charges represent business expenses, so that their sharp acceleration is increasingly eating into profits. In this respect, too, there is a tremendous difference in the development between the early and the late 1990s. During the first half of the decade, the rise in the nonresidential sector's depreciation charges averaged $27.4 billion per year. Between 1996–2001, it averaged $55.4 billion per year. More recently, it has been running at an annual rate of $60–70 billion.

(3) BUSINESS DISSAVING

Business decisions to invest in new plant and equipment are governed by many considerations. One that economists generally neglect is their own balance sheet. In pursuing shareholder value, corporate managers have rampaged the balance sheets of their companies as never before. We are sure that today's badly weakened corporate balance sheets are a main obstacle to stronger business investment.

A key measure of financial strength is cash flow in relation to debts and associated interest expenses. It is typically stressed as positive that corporate interest expenses, despite record levels of debt, nevertheless account for a smaller percentage of corporate cash flow than in the late 1980s. Presumably, this is supposed to suggest that corporate balance sheets are in good shape. Taking a closer look, we think that this is a badly flawed comparison.



To begin with, it needs a critical look at cash flow. Principally, it consists of two components: capital consumption, or depreciation charges, and undistributed profits, also denominated as business saving. Due to the massive shift in corporate

investment toward short-lived investment, as earlier pointed out, capital consumption and depreciation charges almost quintupled between 1980 and 2002 from $231 billion to more than $1,000 billion.

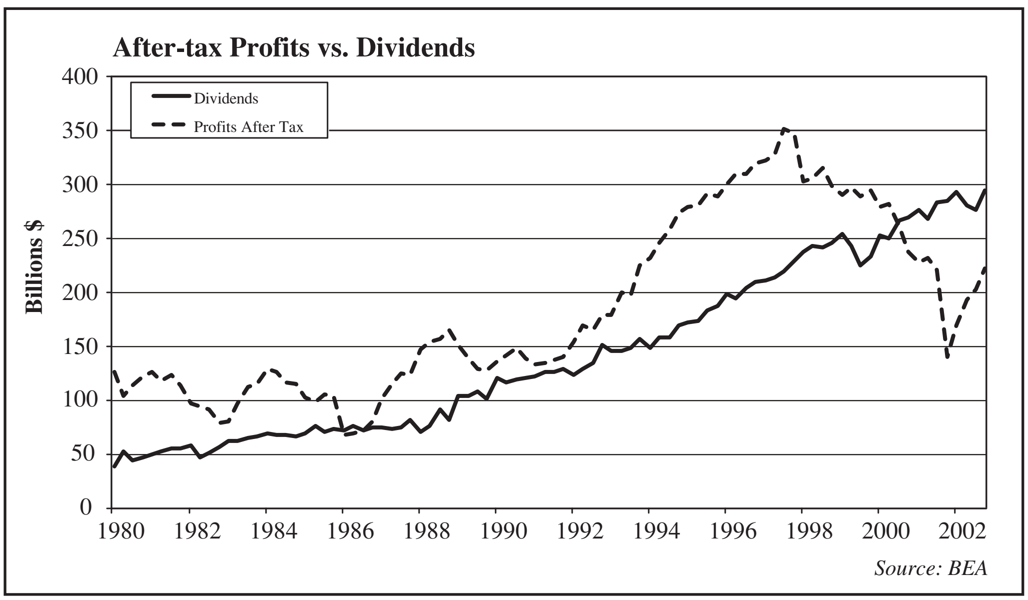
The other cash flow component, undistributed profits, representing business saving, developed in diametric contrast. After averaging 2.9% of GDP from 1950 to 1979, they declined in the 1980s to 1.8%. Falling steeply since 1997, they hit a record low in 2002.

Formally, business depreciation charges rank together with undistributed profits as corporate cash flow or internal funds. That may normally make sense. But when depreciation charges zoom while undistributed profits literally collapse — as during the past years in the United States — then the aggregate becomes highly delusive as a measure of corporate liquidity. Bear in mind that depreciation charges are costs.

In essence, they are a very conditional cash flow. First of all, they have to be earned, but second and above all, it is more than problematical when these funds are used for any other purpose than replacing worn-out capital stock. If that happens on a broader scale, it definitely spells economic depression. The crucial component and measure of corporate liquidity is the relation between total and undistributed profits, in other words, business saving.

Both have plummeted, but undistributed profits have plunged steeply into negative territory. The last time this happened was in the Great Depression. The reason is that corporations keep paying ever-higher dividends, as against ever-lower earnings. Here too, as in many other dismal respects, the year 1997 stands out as the inflection point. Until then, corporations had paid rising dividends from more sharply rising profits, leaving increasing amounts of undistributed profits.

In 1997, nonfinancial corporations paid $218.1 billion in dividends from $337.7 billion in after-tax profits. In 2002, they paid dividends of $285.8 billion, as against sharply lower profits of $197.0 billion. In other words, they financed a substantial and, by the way, growing part of their dividends either by drawing on their cash reserves or by borrowing. In past, more normal times, the distribution was about half-and-half.



In those times, dividend payment trends also used to reflect and herald underlying profit trends. This time, the exact opposite is happening. Dividend payments have been rising to an all-time high as a share of national income, while profits, by the same measure, have fallen to an all-time low.

There can be no doubt about its cause. Outsized dividend payments are instrumental in supporting overvalued stock prices. It may have helped to prevent an even steeper decline of stock prices, yet it grossly failed to stop it. But the flip side, of course, is that balance sheets are not repaired but further rampaged. It is the policy of desperados.

(4) NET INVESTMENT

Now to the chief sources of the profit carnage since 1997 that have been at work on the macroeconomic level. As we have already explained many times, growth of investment in tangible assets — factories,

commercial buildings, machinery — is paramount in creating both national wealth and corporate profits. As usual, we focus on the nonresidential and nonfinancial sector.

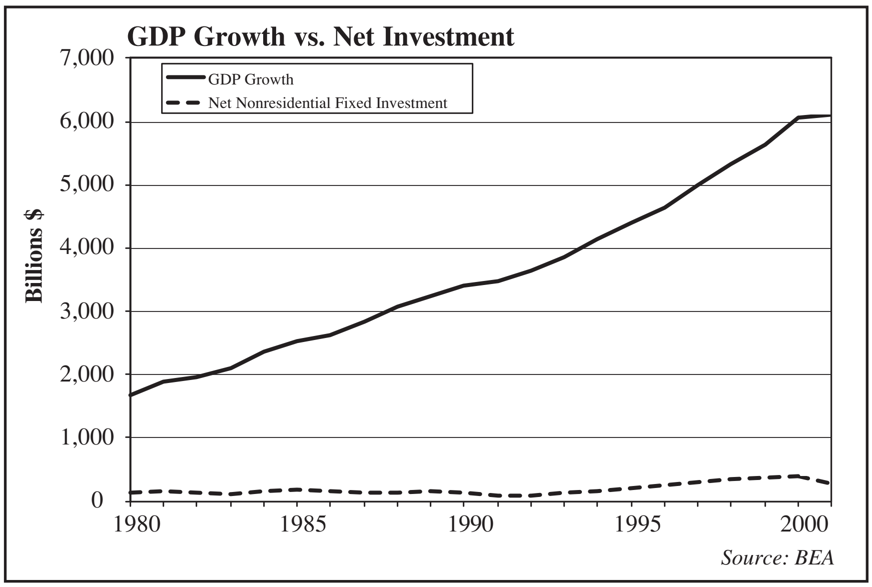
It is a historical fact that high-investment economies are also high-profit economies. The patent explanation is that the high profits are motivating the high investment ratios. But that immediately begs the further question of what is causing the high profits in the first place. From the macroeconomic perspective, for the sake of brevity, it is high investment spending that creates high profits.

Putting it more precisely, high profit expectations induce high rates of capital investment. But it is the high investment spending that makes for their self-fulfillment.

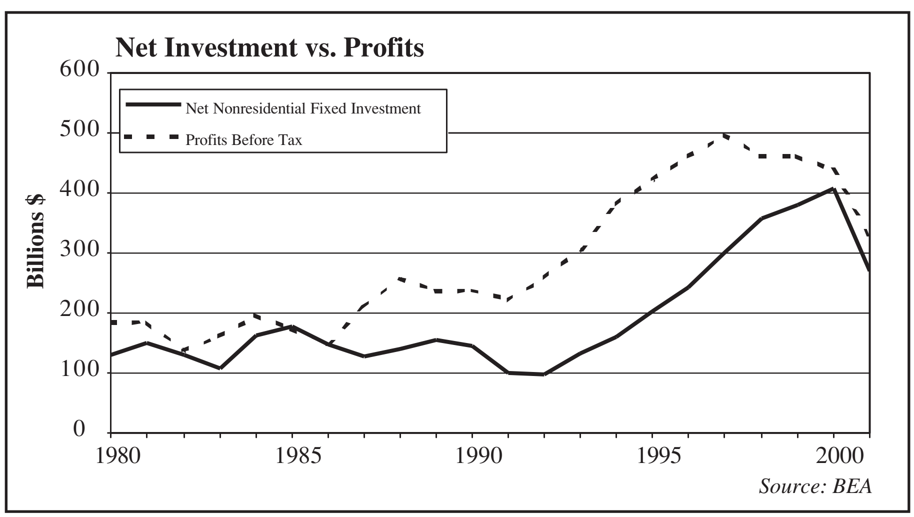
There is a widely held view, in particular in America, that business profits have their main source in consumer spending as the biggest component by far in GDP. It is one of the greatest fallacies in the assessment of the U.S. economy because total consumer incomes, being the main source of his spending — wages, interest, rent, etc. — derive from economic activity; that is, they essentially derive from business spending.

By buying goods and services, the consumer actually recycles business expenses. But to the extent that he saves some part of his current income, his recycling falls short of the amount of expenses that businesses have incurred in their activity. To ultimately make a profit, it essentially needs supplementary business revenue in excess of consumer saving. The main source of this profit-creating part of business sector's revenues is its own spending on fixed investment.

The largest and most important profit source of the business sector is typically its own spending on net fixed investment. This spending is so important because, from a macro perspective, it adds to immediate business revenue without immediate business expense.



This occurs because the investing firms do capitalize the investment expenditures in their balance sheets. They have no expense until the depreciation charges begin a year later. On the other hand, the manufacturer who produces and sells the capital goods registers this in its full amount as immediate revenue. The thing to see is the close causal relationship between business net fixed investment to profit creation.



A sustained economic recovery in the United States requires by all means a strong rebound in net fixed investment and profits. But with depreciation charges at their unusually high level, it needs still higher gross investment to have any increase in net investment. In 2001, it took about 4.5 dollars of gross fixed investment to yield 1 dollar of net addition to the capital

stock. That's abnormally high.

We have identified most of the unfavorable developments in interest and depreciation charges that are directly affecting profits. However, there are many other impediments to economic growth. They are in the balance sheets, in the stock market and in the economy's gross imbalances. A most important one, to which American policymakers and economists are completely blind, is the gaping trade deficit.

(5) THE TRADE DEFICIT

It remains for us most amazing and absolutely incomprehensible how little attention this pernicious economic imbalance finds. It is virtually treated as an emblem of strength. In essence, it reflects a corresponding excess of domestic spending over domestic production.

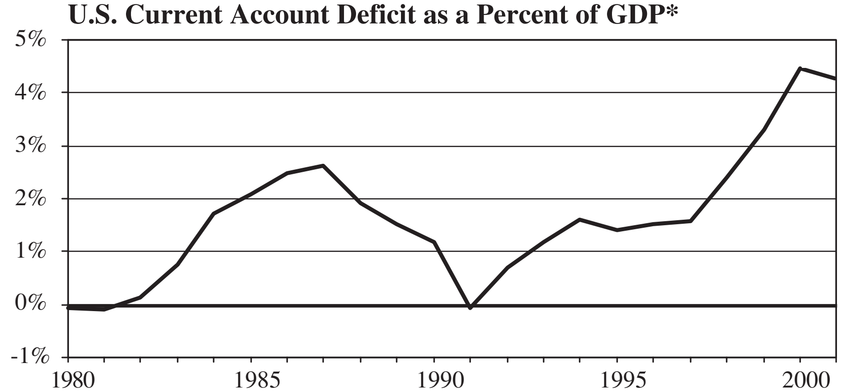
In the United States, it specifically reflects unprecedented overconsumption and undersaving, essentially implying pervasive, deleterious effects on the economy, among them the strangling of manufacturing. Pondering the causes of Corporate America's unusually poor profit performance, we have always focused on the trade deficit's disastrous profit and income effects.

Considering the ups and downs in the U.S. trade deficit since the early 1980s, it strikes the eye that they, too, squarely coincide with the ups and downs in the corporate profit performance. It is, of course, not the only influence; however, it is a major one. During the 1980s, profits performed very poorly until 1986. Then all of a sudden they took off, mainly manufacturing profits. It happened to coincide with a sudden, drastic improvement in the U.S. trade balance.

As described, there followed an unusually steep rise in profits until 1997. Definitely not by accident, these were also the best years for the U.S. trade balance, improving until 1993 and deteriorating rather moderately in the following years. The dramatic turn for the worse both for profits and the trade balance started in precise coincidence after 1997. As the trade deficit exploded, profits imploded. For us, this had strict economic logic.

The close connection between the two arises from the fact that the trade deficit has been driving a growing wedge between U.S. business revenues and business expenses. Clearly, the greatest part of the money that the consumer spends on the soaring import surplus comes from the business sector's wage bill. Instead of recycling it through purchases of domestic goods to domestic producers, he diverts it to foreign producers, boosting their revenues and profits.

U.S. Current Account Deficit as a Percent of GDP*



** There was a trade surplus in 1980, 1981 and 1991* *Source: BEA*

Profits and incomes are created by spending. It should be clear that a diversion of domestic spending to foreign producers to the tune of around $500 billion per year essentially exerts a tremendous drag on incomes and profits in the deficit country. To sustain domestic incomes and spending, it requires more and more domestic credit and debt creation. Obviously, this is a policy for which the day of reckoning is only a question of time.

Ominously, the deficit has been beating ever-new records, even though U.S. domestic demand growth has slowed sharply. In the first quarter of 2003, consumer spending on goods was up $115.7 billion, or .4% year over year, but import of goods had increased $148.5 billion, or 9%.

With the continuation of the consumer borrowing and spending binge, nothing else was to be expected. The February deficit of $40.3 billion was up 22% from its year-ago level. Year-over-year goods imports have risen 12% versus a 5% rise in goods exports.

But this customary comparison of growth rates is grossly misleading because they relate to vastly different export and import levels. The 12% rise in imports relates to annualized goods imports of around $1,300 billion in early 2002, while the 5% rise in exports relates to annualized goods exports of about $700 billion at that time.

Do not expect any relief. The trade deficit is destined to swell further, if only because the math of the gap has become so daunting. Imports of goods and services are now 1.5 times larger than their exports. This means that exports have to grow 1.5 times faster than their imports just to keep the deficit from widening further. Like many other things, the U.S. trade deficit is completely out of control.

As explained earlier, by diverging huge flows of domestic income to foreign producers, the trade deficit has been driving a growing wedge between U.S. corporate revenue and expenses. This wedge is widening at a rapidly accelerating pace, spelling correspondingly more profit troubles from this source. Instead of adjustment, there is dramatically worsening maladjustment.

DEFLATION NONSENSE

Being unable to see any self-made problem in the U.S. economy and its financial system, American policymakers and economists have discovered deflation — in other words, the lack of corporate pricing power — as the main culprit behind Corporate America's miserable profit performance.

For us, this explanation is an outright joke. Think of it: for many years now the U.S. economy has been treated with the most prodigious money and credit creation in history, not only in absolute numbers, but above all in comparison to current GDP and income growth.

Between 1997–2002, GDP grew by $2,127 billion and national income by $1,769 billion. Over the same period, nonfinancial nonfederal credit has exploded by about $5.6 trillion and financial credit by another $4,860 billion, adding up to an overall increase by about $10.4 trillion. For each dollar added to national income, $3.3 was added to private sector indebtedness.

As to the consumer, he increased his indebtedness over this period by $2,843 billion, as against an increase in his disposable income by $1,806 billion. It is widely hailed as a great positive that his interest burden is nevertheless below its peak in the 1980s. But the reasons for that are, of course, the record-low interest rates for consumer borrowing that Mr. Greenspan has engineered and that are propelling this grossly unreasonable borrowing binge.

For each dollar added to his disposable income, the consumer has added $1.57 to his indebtedness in these years. This debt-to-income ratio had hovered between 0.24–0.29 during the 1960–70s. It jumped in the 1980s to 0.44. During 2001–02, with aggregate personal income up $695 billion (heavily bolstered by tax cuts) and indebtedness up $1,330 billion, this ratio has been racing towards 2, implying almost two additional debt dollars for one additional income dollar.

A widespread happy-go-lucky assumption appears to prevail that debts can be serviced indefinitely by new borrowing. As persistent subpar economic growth, low inflation rates and buoyant credit flows seem to give a virtual assurance of sustained low interest rates, and lenders readily capitalize unpaid debt service.

Unfortunately, there is a snag, and that is rapidly compounding interest rate expenses. In order to just maintain the credit expansion's spending and income effects, new borrowing and lending has to compound itself just as fast. For us, this is the main explanation why Mr. Greenspan's ultra-easy money is so successful in accelerating credit and debt growth, but so unsuccessful in maintaining inherent spending and income effects. More and more of the accelerating credit growth reflects the capitalization of unpaid interests on the part of the lenders.

THE DOLLAR THREAT

Is this horrendous debt growth sustainable? Of course not. Essentially, there comes a point where interest expenses effectively have to be paid. And that, after all, will be the day of reckoning for consumer spending.

In our view, the greatest threat for the U.S. economy and its financial system looms in the monstrous trade deficit and the dollar. The reason is that over time a prolonged plunge of the dollar is sure to create great uncertainties in the U.S. financial markets. It will complicate Federal Reserve policy, lift inflation and pose further capital inflows into question. All this would tend to drive up interest rates with calamitous effects on the bond market where leveraging is rampant.

Falling import prices, down more than 10% since 1995, have played a key role in containing U.S. inflation rates. But last March, overall import prices were up 6.7% year-over-year. Ex-petroleum prices jumped 0.9%, the strongest rise in more than a decade, and with a year-over-year gain of 2.4%. Domestic producer prices were up 4.2% year-over-year. Among them were consumer prices with 5.6%, capital equipment prices with 0.4% and energy prices with 26.5%.

CONCLUSIONS

Regarding profits as the capitalist economy's lifeblood, we have tracked the major influences impinging on U.S. corporate profitability, operating both on the micro and the macro level. Our findings have been extremely negative. On both levels, there is nothing in sight that could promise higher profits.

Don't be fooled by the first quarter's reported growth rate of 1.6%. That's annualized. The reality is 0.4%.

It still seems to us that pervasive optimism about the U.S. economy is preventing the dollar's steeper plunge that we consider inevitable. As it happens, the stage will be set for steeply rising longer-term interest rates.

THE RICHEBÄCHER LETTER

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